PEABODY COAL CO.

IBLA 95-219 Decided November 17, 1997

Appeal from a finding by the Minerals Management Service that the price received for run-of-mine coal did not amount to full value of the coal for royalty purposes. MMS 91-0370-MIN.

Affirmed.

1. Coal Leases and Permits: Royalties

Departmental regulations governing coal valuation require a lessee to pay royalties on the value of coal after primary crushing, the cost of which must be included in gross proceeds, although the lessee has an arm's-length agreement with a purchaser who assumes the cost of such crushing.

APPEARANCES: Michael E. Hyer, Esq., Flagstaff, Arizona, for Peabody Holding Company, Inc.; Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, for Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE ARNESS

Peabody Coal Company (Peabody) has appealed from a September 19, 1994, determination by the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), that upheld an MMS Royalty Valuation Order dated May 28, 1991 (Docket No. MMS-RVS-SM:90-0627), requiring payment of additional royalties on coal mined from Federal Coal Leases numbered C-081251, C-081258, C-088199, C-114093, and C-019885, comprising Peabody's Seneca II Mine in northwest Colorado. The question presented by Peabody's appeal is whether the cost of primary crushing of run-of-mine coal by a purchaser should be included in gross proceeds for calculating royalties owed to the United States by Peabody. We conclude that the value of such crushing must be included when making the royalty computation.

Peabody produces coal from the Seneca II Mine by surface mining methods, and sells it to the Hayden Station Power Plant (Hayden), pursuant to a coal supply agreement with Hayden owners. (Peabody Statement of Reasons at 1.) Coal is loaded from the Seneca II mine pit into trucks and hauled about 15 miles to Hayden. There, Peabody delivers the coal run-of-mine, that is to say, uncrushed, "exactly as it comes from the pit." (MMS Field Report dated Nov. 19, 1991, at 6.) At Hayden, the coal is dumped through a grid grizzly maintained by Peabody into Hayden's hopper which feeds the primary crushers, owned and chiefly maintained by Hayden. After primary crushing, the coal is run through a secondary crusher and then stockpiled. The coal is weighed for payment and royalty purposes while on conveyors at Hayden between primary and secondary crushing.

Citing Departmental regulations governing coal valuation on Federal leases that require lessees to place coal in marketable condition at no cost to the lessor, MMS found primary coal crushing is necessary to place coal in marketable condition; therefore, the cost of primary crushing facilities and operations could not be deducted from gross proceeds in order to establish value for royalty purposes. (Royalty Valuation Order dated May 28, 1991, Encl. 1, at 8.) The MMS concluded that, as primary crushing is normally a mining operation, Hayden had granted "noncash" consideration to Peabody, and that, under royalty valuation regulations, the cost of primary crushing must be added to the sales price of the coal to arrive at gross proceeds accruing to the lessee for royalty computation. Accordingly, MMS directed Peabody to submit additional information relevant to "determining the cash equivalency of the noncash benefits provided by use of [the Hayden] crushing facility" beginning with the May 1985 sales month. (Royalty Valuation Order at 2.)

Peabody appealed from this order to the Director, MMS, alleging it was "based on a common erroneous factual conclusion." Peabody argued, before the Director, that MMS found in error that run-of-mine coal is not in marketable condition. Since the market segment into which the coal is sold does not include rail transportation, Peabody maintained, there is no need for primary crushing for the coal to become marketable. Peabody also argued that the coal supply agreement with Hayden was an arm's-length transaction, "likely motivated by operational efficiencies" and not the result of royalty valuation considerations or collusion.

The Associate Director rejected Peabody's arguments, concluding that the MMS determination was "fully consistent with announced agency policy and with the pertinent regulations." (Decision at 5.) She found "primary crushing" to be "a standard mining operation required by the steam electric utility market segment the coal is sold into," and noted that this initial process is "generally necessary in order for a mine to handle, store, and load coal." Id. at 4. She also found that "MMS has been consistent in holding that the performance of this function is a necessary part of placing the coal in marketable condition" and held that "[p]rimary crushing is a fundamental requirement universally recognized in the coal mining industry as necessary to place coal in marketable condition." Id. at 4, 5.

Peabody then appealed to this Board, repeating arguments raised before and relying on language in a January 13, 1989, revision of the coal product valuation regulations, which states: "[T]he marketable condition requirement is as flexible as the requirements of the different market segments." 54 Fed. Reg. 1498 (Jan. 13, 1989). Peabody argues that, for royalty valuation purposes, whether run-of-mine coal is in marketable condition depends on whether a buyer will accept it. It is said that if a buyer requires delivery by rail, then the coal is not marketable until it has undergone processing necessary for rail transportation. But if the buyer accepts run-of-mine coal in an arms-length transaction, according to Peabody, the seller's "market segment" does not require primary crushing, and a seller should not be made to bear the cost of such processing when royalty payments to the United States are calculated.

[1] The Federal coal leases comprising the Seneca II mine require Peabody to pay royalties as a percentage of the value of coal produced, as defined by regulation. From May 1, 1985, through March 1, 1989, the coal royalty valuation regulations provided that when "Federal royalty is calculated on a percentage basis, the value of coal for Federal royalty purposes shall be the gross value at the point of sale," provided that "costs of primary crushing," however, "shall not be deducted from the gross value in determining value for Federal royalty purposes." 30 C.F.R. § 203.200, redesignated as 30 C.F.R. § 203.250(f) and (h); 53 Fed. Reg. 1218 (Jan. 15, 1988).

On January 13, 1989, MMS published revised coal valuation regulations. Instead of "gross value," the revised regulations speak in terms of "gross proceeds," defined to include "payments to the lessee for certain services such as crushing." 30 C.F.R. § 206.251 (1989). Revised valuation standards for ad valorem leases are set forth at 30 C.F.R. § 206.257 (1989). Under this rule, "[t]he value of coal that is sold pursuant to an arm's-length transaction shall be the gross proceeds accruing to the lessee." 30 C.F.R. § 206.257(b)(1) (1989). A lessee is required, under these rules, to place coal in marketable condition "at no cost to the Federal Government." 30 C.F.R. § 206.257(h) (1989). The latter rule states also that when gross proceeds are reduced by a purchaser who provides services to make coal marketable, the value of those services will be included as part of gross proceeds.

Peabody argues that the 1989 final rulemaking supports a notion that run-of-mine coal is not subject to this rule if it is sold in a market not requiring rail delivery. The rulemaking, however, unambiguously rejects this interpretation, stating that

> under no circumstances will MMS accept the gross proceeds established under any sale of coal that does not meet the market's requirement for marketable condition. Specifically, the sale of run-of-mine coal for steam coal utilization by an electric utility does not constitute coal in marketable condition. In this situation, MMS will add to the gross proceeds the cost of those normal mining processes which are ordinarily the responsibility of the lessee. This provision is explicitly set forth at § 206.257(h).

54 Fed. Reg. 1498-99 (Jan. 13, 1989).

This method of royalty valuation has been approved in the case of potash treated for market. United States v. Southwest Potash Corp., 352 F.2d 113 (10th Cir. 1965), cert. denied, 383 U.S. 911 (1966). The Board has upheld the same approach under valuation regulations pertaining to sweetening sour gas, Texaco, Inc., 134 IBLA 109 (1995), and compressing gas. R.E. Yarbrough & Co., 122 IBLA 217 (1992). The leases here at issue require that the value of production royalty be determined under regulations in effect when royalties are due. The regulations in effect at all times unambiguously required a coal lessee to pay royalties on coal that is marketable; until the coal is in condition to be sold in the marketplace, it cannot be said to be marketable. Peabody has not shown that its coal can be marketed without primary crushing. The fact that the coal at issue was not measured for sale until after primary crushing at the Hayden facility is indicative of the underlying practical consideration that, as MMS found, "virtually all coal produced from surface operations requires size reduction in order to be manageable by both the lessee and the coal purchaser." (MMS Field Report at 6.) The cost of primary crushing was properly included by MMS when calculating coal royalty under Departmental regulations in effect at all relevant times at issue herein.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the Decision appealed from is affirmed.

Franklin D. Arness
Administrative Judge

ADMINISTRATIVE JUDGE MULLEN CONCURRING IN THE RESULTS:

I agree with the results but cannot join in the Decision because of my concern regarding the wording of the opinion.

For example, the opinion states that

> [f]rom May 1, 1985, through March 1, 1989, the coal royalty valuation regulations provided that when "Federal royalty is calculated on a percentage basis, the value of coal for Federal royalty purposes shall be the value at the point of sale" provided that "costs of primary crushing" however, "shall not be deducted from the gross value in determining value for Federal royalty purposes." 30 C.F.R. § 203.200, redesignated as 30 C.F.R. § 203.250(f) and (h) (53 Fed. Reg. 1218 (Jan. 15, 1988)).

However, 30 C.F.R. § 203.200(f) and (h) (1987) reads as follows:

> (f) Where Federal royalty is calculated on a percentage basis, the value of coal for Federal royalty purposes shall be the gross value at the point of sale, normally the mine, except as provided at 30 CFR 203.200(h).
>
> * * * * * * *
>
> (h) If additional preparation of the coal is performed prior to sale, such costs shall be deducted from the gross value in determining the value for Federal royalty purposes. The District Mining Supervisor will allow such deductions only when, in his judgment and subject to his audit, the operator/lessee provides an accurate account of the costs incurred. However, the following shall not be deducted from the gross value in determining value for Federal royalty purposes: costs of primary crushing storing, and loading; * * * and other preparation of the coal which in the judgment of the District Mining Supervisor do not enhance the quality of the coal.

The intent of the above quoted language was to disallow deduction of costs which, in the ordinary course of business, are necessary to render the coal marketable. The opinion states that "'primary crushing' however, 'shall not be deducted from the gross value in determining value for Federal royalty purposes.'" The regulation did not dictate a flat prohibition of the deduction of the cost of primary crushing.

The opinion states that the leases "require that the value of production royalty be determined under regulations in effect when the royalty is due." The production royalty is not in issue. The issue is the value of the coal to which the royalty is applied for the purpose of determining the amount due. A lease readjustment is necessary to change the production royalty. See, e.g., Western Fuels-Utah, Inc., 135 IBLA 187 (1996). The production royalty in a coal lease cannot be changed by amending a regulation.

R.W. Mullen
Administrative Judge